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No. 357

In the Supreme Court of the United States

OCTOBER TERM, 1960

UNITED STATES, PETITIONER

v.

CONSOLIDATED EDISON COMPANY OF NEW YORK, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

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OPINIONS BELOW

The opinion of the District Court (R. 3) is unreported. The opinion of the Court of Appeals (R. 39-50) is reported at 279 F. 2d 152.

JURISDICTION

The judgment of the Court of Appeals was entered on May 25, 1960. (R. 51.) The petition for a writ of certiorari was filed on August 23, 1960, and was granted on November 14, 1960. 364 U.S. 890. (R.

52.) The jurisdiction of this Court rests upon 28 U.S.C., Section 1254(1).

QUESTIONS PRESENTED

1. Whether, for federal income tax purposes, a contested property tax liability was deductible by the taxpayer (which is on the accrual basis of accounting) in the taxable year in which the liability was discharged by payment made under protest, or in a subsequent taxable year in which a suit for refund of a portion of the payment was settled.

2. Whether the portion repaid to the taxpayer in settlement of its refund suit is includible in its gross income in the year of settlement.

STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * *

(c) [as amended by Sec. 202(a), Revenue Act of 1941, c. 412, 55 Stat. 687] *Taxes Generally.*—

(1) *Allowance in general.*—Taxes paid or accrued within the taxable year. * * * [with exceptions not material here].

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period

(fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, *supra*]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED—

(a) *General rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to

clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1952 ed., Sec. 43.)

SEC. 48. DEFINITIONS.

When used in this chapter—

(a) *Taxable year.*

"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. * * *

* * * *

(c) *"Paid or incurred," "paid or accrued."* The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * *

(26 U.S.C. 1952 ed., Sec. 48)

STATEMENT

The taxpayer, a public utility corporation, keeps its books and files its returns on a calendar year-accrual basis. (R. 40.) It owns considerable real estate in New York City on which it pays local property taxes. The taxes are assessed by applying the tax rates established by the City Council to the final assessed valuations fixed by the City Tax Commission. (R. 43.) In each of the years 1938-1950, with the exception of 1942 and 1943, the taxpayer contested part of the taxes so imposed; but before the end of each of those years, the taxpayer's protest was over-

ruled by the taxing authorities, the proposed assessment became administratively final, and the full amount of the taxes was paid by the taxpayer under protest and for the stated purpose of avoiding liens, seizures, and penalties. (R. 5-6, 42-43.) Although payment was not a requisite to judicial review in the form of prescribed certiorari proceedings in the New York courts, it was necessary to stay the imposition of penalties and the foreclosure of liens. (R. 18.)

The New York certiorari proceedings instituted by the taxpayer with respect to the years 1938-1940 were concluded in 1941 by a settlement which fixed the taxes at a somewhat lower figure than the taxes assessed. The difference (which was substantially less than the recovery sought by the taxpayer) was refunded. In 1951, there was a similar settlement of certiorari proceedings instituted by the taxpayer with respect to the years 1946-1950. (R. 43.) Only the latter years and the settlement of the claims made in relation to those years are involved in this action.

To facilitate consideration of the questions presented, the following example was stipulated by the parties (and used by the court below) as applicable to all of the years here involved (R. 10, 41-42):

(a) for the year 1949 plaintiff was notified, on January 25, 1949, of a tentative assessment in the amount of	$100.
(b) plaintiff duly filed by March 15, 1949, a bona fide protest, admitting liability of	85.
and petitioning for an administrative reduction of said tentative assessment by	15.
(c) after hearing duly held and on or about May 25, 1949, final assessment was made in the amount of	100.

(d) thereafter on or about October 1, 1949, under protest and for the stated purpose of avoiding liens, seizures, levies, penalties, interest, etc., and reserving all rights, payment was made of 100.

(e) on October 25, 1949, certiorari proceedings were duly instituted in the New York Supreme Court admitting liability of, and denying liability in excess of 85.

(f) in December, 1951, the certiorari proceedings were settled, fixing the tax liability at 95. and establishing an overpayment which was duly refunded, in the amount of 5.

In its federal income tax returns for the taxable years 1946-1950, the taxpayer claimed as a deduction, each year, the full amount of the property tax paid under protest in that year, and the claimed deductions were allowed by the Commissioner. (R. 22.) In its return for the taxable year 1951, the year in which it received, pursuant to the settlement, a refund of a portion of the amount previously paid and deducted, it included the amount refunded in gross income. Thereafter, the taxpayer brought the present suit to recover an alleged overpayment of federal income tax for 1951, contending (1) that it should have deducted, in the years 1946-1950, only the portion of the property tax which it did not contest, (2) that it should be permitted to deduct, in 1951, the portion of the contested amount which was recognized in the 1951 settlement as having been properly assessed, and (3) that it should not have included in its 1951 income the refunded portion of the payment. (R. 13-15.) The Government opposed taxpayer's claim of overpayment of its 1951 federal income tax, on the ground

that taxpayer had properly deducted the entire amount of the property tax in the years of payment and had properly included in its gross income for 1951 the amount refunded under the settlement reached in that year.[1] (R. 42-43.)

The District Court granted the Government's motion for summary judgment, following the decision of the Court of Claims in *Consolidated Edison Co. of New York* v. *United States*, 135 F. Supp. 881, certiorari denied, 351 U.S. 909. (R. 3.) The Court of Appeals for the Second Circuit reversed, Judge Clark dissenting. (R. 39-50.)[2]

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[1] In terms of the stipulated example, taxpayer, in its 1949 return, claimed, and was allowed, a deduction of $100 (the full amount of its payment); and in its 1951 return included in gross income $5 (the portion refunded). It now contends that, in 1949, it should have deducted only $85 (the uncontested portion of the payment), that it should be permitted to deduct in 1951 an additional $10 (the additional amount recognized in the settlement as properly assessed), and that it should have excluded from its 1951 income the $5 refunded under the settlement. The Government contends that taxpayer properly deducted the entire $100 payment in 1949, and properly included the $5 refund in its 1951 income.

[2] The Government also raised an affirmative defense of collateral estoppel, invoking the decision of the Court of Claims in *Consolidated Edison Co. of New York* v. *United States, supra*. The Government's motion for summary judgment based on this defense was denied by the District Court (162 F. Supp. 854), and that ruling was affirmed by the Court of Appeals. (R. 40-47.) The point is not presented by the petition filed in this Court.

SUMMARY OF ARGUMENT

This case turns on the application of settled tax accounting principles to a taxpayer which files its returns on the accrual basis, pays a contested liability under protest and, in a taxable year subsequent to payment, recovers a portion of the payment in settlement of a refund suit.

I

It is settled by numerous decisions of this Court that, for federal income tax purposes, gross income and items of deduction must be accounted for on an annual, rather than on a transactional, basis. This is so irrespective of whether the taxpayer employs the cash or the accrual method of accounting. As applied to taxpayers using the accrual method, the annual accounting rule requires that an item of gross income be reported in the taxable year in which the right to receive it becomes fixed; conversely, an item of deduction is to be taken in the taxable year in which the liability to pay it becomes fixed, both in fact and in amount. It is also settled, as a corollary to these principles, that an *unpaid contested* liability does not become fixed, and hence is not deductible by an accrual-basis taxpayer, unless and until the contest is terminated adversely to the taxpayer.

The narrow issue here is whether an accrual-basis taxpayer which *pays* a local property tax assessment under protest, and then sues to recover part of the payment, may postpone the year of accrual beyond

the year of payment.[3] The Court of Claims has twice held that the deduction may be taken only in the year of payment, albeit the payment was made unwillingly and suit for its recovery was brought; one of those cases involved the same taxpayer and the same set of facts as the instant case, but different taxable years. *Consolidated Edison Co. of New York v. United States*, 135 F. Supp. 881, certiorari denied, 351 U.S. 909. The Tax Court has similarly so held. We urge that these decisions represent the correct view.

Payment by a debtor to his creditor of an asserted liability operates to discharge the liability, even though the payment is made under protest and the debtor seeks (immediately or subsequently) to recover it in whole or in part. And, once the asserted liability has been satisfied, there is no warrant for assuming that it has not yet accrued for tax deduction purposes. Nothing in the decided cases (other than the majority opinion below) supports taxpayer's contention that one who has discharged a contested liability by payment may defer its deduction to a year subsequent to that of payment merely because the payment was made under protest and a refund is claimed. On the contrary, in holding that an *unpaid* contested liability is not deductible by an accrual-basis taxpayer prior to the year in which the contest

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[3] Although a number of payments of city tax assessments for each of several years are involved, for convenience the assessments and payments are sometimes referred to in the singular. See also the stipulated illustrative example (R. 10), and footnote 5, *infra*.

is terminated, this Court indicated that the result would have been different had the contested liability been *paid*. *Security Mills Co.* v. *Commissioner*, 321 U.S. 281; *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516. The rationale of the decisions which preclude accrual of an *unpaid* contested liability—the uncertainty that the disputed obligation would ever be paid—calls for accrual where, as here, a contested tax liability has been finally assessed and paid; the only contingency which then remains relates to the taxpayer's right to the claimed refund.

Whether, under commercial accounting practice, it would be customary to accrue the payment in question does not determine whether accrual was proper for *tax accounting* purposes. As a matter of fact, however, taxpayer's returns did treat the amount paid as an expense incurred and deductible in the year of payment.

Had taxpayer employed the cash method of accounting, all other facts being the same, it admittedly would have been required to deduct the payment in question in the year of payment, notwithstanding the institution of a suit for refund. Since the accrual method of accounting contemplates that deductions are ordinarily to be taken in a year *prior* to that of actual payment, *i. e.*, in the year when the liability to pay becomes definite, *a fortiori* an accrual-basis taxpayer should not be able to postpone deduction beyond the year of actual payment. As the Court of Claims has said (*Chestnut Securities Co.* v. *United States*, 62 F. Supp. 574, 576), "Accrual, from the debtor's standpoint, precedes payment, and does not

survive it". Again, had the payment in question been made without protest, *e. g.*, under a misapprehension or mistake, it clearly would have been deductible in the year of payment, despite the institution of a refund suit and the probability that the payment would be recovered. And, viewing the matter from the standpoint of a payee (whether he be on the cash or accrual basis), he plainly receives income when a disputed claim is paid, even though the payor plans to seek restitution.

Practical considerations strongly support the view we urge. Certainly, it is desirable that objective and readily ascertainable criteria determine the proper year of accrual as well as other taxable events. Payment of an asserted liability, whether voluntarily made (with or without protest) or involuntarily made through seizure of a debtor's assets, is a definitive event—an actual expenditure which leaves the debtor out-of-pocket. To permit a taxpayer to postpone a deduction, when that course offers the possibility of tax advantage, by making a claim for refund of a paid obligation and keeping that claim alive until he chooses to terminate it, is to invite the "astute accountant" (see the dissenting opinion of Judge Clark, R. 48) to manipulate income tax consequences in disregard of the annual accounting principle.

Since, under our analysis, the critical event is the fact of payment, we emphasize that there is no question in this case that the remittances made by taxpayer to the City of New York were true payments—not, for example, the mere posting of security—and that they fully extinguished the obligation in satisfaction of which they were tendered.

II

If the liability in question was accruable and deductible in the year of payment, as taxpayer treated it in its returns and as the Government contends, then the portion refunded to the taxpayer in a subsequent year, in settlement of its refund suit, is includible in its gross income in the year of settlement. This result follows from application of the annual accounting rule and the corollary tax-benefit doctrine. Taxpayer conceded the point in the court below, and presumably does not dispute it here.

ARGUMENT

This case involves the application of established principles of federal income tax accounting to a taxpayer which (1) files its returns on the accrual basis; (2) contested a local property tax liability asserted against it; (3) pursuant to a final administrative assessment of the tax, discharged the liability by making payment under protest; and (4) in a subsequent taxable year, in settlement of a refund suit, recovered a portion of the payment.

In its returns, the taxpayer deducted the full amount of the payment in the taxable year in which it was made (1949), and included the portion refunded in its gross income for the year of recovery (1951). This approach, we believe, was correct. Taxpayer now contends, however, that it should have deducted, in the year of payment, only that portion of the liability which it did not contest; that it should have deducted, in the year of settlement and refund,

an additional portion, representing the additional amount recognized by the settlement as having been properly assessed; and that it should not have included the refunded portion in its 1951 income. It is the Government's position, based upon the decision of the Court of Claims in *Consolidated Edison Co. of New York* v. *United States, supra*,[4] that the taxpayer's original returns were correct, and that its present claim of overpayment of 1951 federal income tax was properly rejected by the Commissioner and the District Court.[5]

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[4] The Court of Claims in *Consolidated Edison Co.* followed its prior decision in *Chestnut Securities Co.* v. *United States, supra.*

[5] In terms of the stipulated illustration (R. 10, 42), the controversy as to the proper year of deduction is confined to the $15 portion of the $100 tax assessed against and paid by taxpayer, that being the only portion contested by it. The parties are in agreement that the uncontested portion ($85) is deductible only in the year of payment (1949).

As to the $15 portion, it is the Government's position that all of it was likewise deductible in the year of payment, and that the $5 subsequently repaid on settlement of the refund suit was includible in taxpayer's gross income in the year of settlement (1951). On the other hand, it is taxpayer's position that no part of the $15 paid was deductible in the year of payment, that the $10 difference between that amount and the $5 later refunded was deductible in the year of settlement, and that the $5 refunded should have been excluded from its gross income.

I

When the Taxpayer Discharged Its Liability for the Contested Property Taxes by Payment Under Protest, the Liability Accrued for Federal Income Tax Purposes

A. *The applicable principles of tax accounting.*

Taxpayer keeps its books and files its federal income tax returns on the accrual basis. (R. 40.) Consequently, under the applicable federal tax statutes,[6] it may deduct its local property taxes only in the year in which those taxes accrue as a liability. *Security Mills Co.* v. *Commissioner*, 321 U.S. 281; *United States* v. *Anderson*, 269 U.S. 422. Taxpayer, having elected to use the accrual method, must apply it consistently, and neither taxpayer nor the Government may cause an item to be reported in a year other than that in which it accrues. *United States* v. *Olympic Radio & Television*, 349 U.S. 232; *United States* v. *Anderson, supra; Security Mills Co.* v. *Commissioner, supra*, pp. 286-287.

The date of accrual of an item for federal tax purposes does not necessarily coincide with that of its accrual under commercial accounting practice (which, incidentally, is not invariably uniform). *Lucas* v. *American Code Co.*, 280 U.S. 445, 452; *Brown* v. *Helvering*, 291 U.S. 193, 202; *Bazley* v. *Commissioner*, 331 U.S. 737, 741.[7] See Recommendations to Con-

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[6] Sections 23(c), 41, 42, 43 and 48 of the Internal Revenue Code of 1939, *supra*, pp.

[7] As this Court stated in *Weiss* v. *Wiener*, 279 U.S. 333, 335:

> The income tax laws do not profess to embody perfect

gress by the American Institute of Accountants Regarding Divergencies Between Rules of Tax Accounting and Generally Accepted Accounting Principles, 97 Journal of Accountancy 93 (1954). Taxable income must be computed on an annual accounting basis; each "taxable year" is treated as a separate unit, and all items of gross income and deduction are reflected in terms of their posture at the close of the year, irrespective of subsequent events or the final outcome of a particular transaction. *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 363-365; *Heiner* v. *Mellon*, 304 U.S. 271, 275; *Guaranty Trust Co.* v. *Commissioner*, 303 U.S. 493; *Brown* v. *Helvering*, *supra*; *Security Mills Co.* v. *Commissioner*, *supra*. The rationale of the system was stated by the Court in *Security Mills* as follows (321 U.S., at 286):

> "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation."

The touchstone for determining when items accrue as deductions under the annual accounting system is the "all events" test established by this Court more than thirty-five years ago in *United States* v. *Anderson*, 269 U.S. 422. In that case, the Court held that

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economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer.

* * *

a munitions tax assessed and paid in 1917 accrued as a tax deduction in the *prior* year in which the taxpayer's liability for the tax became definite. The Court stated (269 U.S. at 440-441):

> Only a word need be said with reference to the contention that the tax upon munitions manufactured and sold in 1916 did not accrue until 1917. In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and become due; but it is also true that in advance of the assessment of a tax, *all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.* * * * (Emphasis added.)

The "all events" test has been reaffirmed by this Court on numerous occasions, and is now a fundamental principle of tax accounting. *E.g.*, *Lucas* v. *American Code Co.*, 280 U.S. 445; *Brown* v. *Helvering*, 291 U.S. 193; *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516, 519; *Security Mills Co.* v. *Commissioner*, 321 U.S. 281, 284. In the Court's words (*Security Mills* case, pp. 286-287):

> This legal principle has often been stated and applied. The uniform result has been denial both to the Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, *or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.*
>
> But the petitioner urges that § 43 has altered the rule so that a hybrid system, partly annual and partly transactional, may, within adminis-

> trative discretion, be substituted for that of annual accounting periods. * * * The very section on which petitioner relies, however, reiterates the adherence of Congress to the system of annual periods of computation. (Emphasis added.)

In *Lewyt Corp.* v. *Commissioner*, 349 U.S. 237, the Court once more restated these principles, observing, with respect to the accrual of a tax liability, that (p. 242) "the concept 'accrued' embodies the annual accounting principle."

B. *Under the annual accounting system, a liability accrues no later than the date on which payment is made.*

In *Dixie Pine Co.* v. *Commissioner, supra*, the Court added a refinement to the "all events" test. In that case, the taxpayer had accrued as a federal tax deduction the amount of a state gasoline tax which it had not paid and was contesting. The Court held that the taxpayer could not deduct the unpaid item prior to the termination of the contest.

Again, in *Security Mills Co.* v. *Commissioner, supra*, the Court held that a contested *unpaid* liability did not accrue as a deduction until the contest was settled. In that case, the Court disallowed deductions taken by the taxpayer for processing taxes which it had not paid [8] and was contesting. It stated (321 U.S. at 284):

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[8] A large portion of the item in dispute in *Security Mills* had been paid by the taxpayer into a depository. Such a deposit does not constitute a "payment". See Point IC, *infra*, pp. 26-30. While the court did not expressly discuss that question, it treated the item as unpaid. 321 U.S. at 284.

> It is settled by many decisions that a taxpayer may not accrue an expense the amount of which is unsettled or the liability for which is contingent, and this principle is fully applicable to a tax, liability for which the taxpayer denies, *and payment whereof he is contesting.* Here the petitioner, in figuring its costs and its sales price to consumers, added the amount of the processing tax, but it collected its purchase price as such and designated no part of it as representing the tax. The petitioner received the purchase price as such. Its tax liability, if any, to the United States, did not differ from other debts. Since it denied liability for, *and failed to pay,* the tax during the taxable year 1935, it was not in a position in its tax accounting to treat the Government's claim as an accrued liability. As it admittedly received the money in question in 1935 and could not deduct from gross income an accrued liability to offset it, the receipt, it would seem, must constitute income for that year. (Emphasis added.)

The decisions in *Security Mills* and *Dixie Pine* are rooted in the "all events" principle. Of course, when the taxpayer is contesting its liability to pay an item, its liability is contingent and cannot be deemed to have accrued. However, when the taxpayer pays the item and thereby discharges its liability, the expense has been incurred and there is no longer any contingency which would prevent its accrual. The liability has "vested", even though there is a possibility —one not susceptible of prediction or measurement— of "defeasance." Significantly, in both *Dixie Pine* and *Security Mills*, the Court stressed that the lia-

bility there involved had not been paid. In *Security Mills* particularly, the Court implied that a contested liability accrues when paid; it said (321 U.S. at 284) that the taxpayer could not accrue the tax there involved because it had denied liability for "and failed to pay" it.

Shortly after the decision in *Security Mills*, the Court of Claims held that a contested tax liability accrued on the date of payment even though payment was made under protest and the contest was continued after that date. *Chestnut Securities Co.* v. *United States*, 62 F. Supp. 574 (C. Cls.). The court stated (p. 576):

> One is not entitled to accrue a debt or other liability which is asserted against him but which he disputes and litigates, until the litigation is concluded. But if a liability is asserted against him and he pays it, though under protest, and though he promptly began litigation to get the money back, the status of the liability is that it has been discharged by payment. It is hardly conceivable that a liability asserted against him, which he has discharged by payment, has not yet "accrued" within the meaning of the tax laws and the terminology of accounting. Accrual, from the debtor's standpoint, precedes payment, and does not survive it.

The Tax Court has reached the same conclusion. *Lehigh Valley Railroad Co.* v. *Commissioner*, 12 T.C. 977;[9] *Western Cartridge Co.* v. *Commissioner*, 11 T.C.

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[9] In the *Lehigh* case, the taxpayer paid, each year, the amount of a state railroad property tax that it admitted to be due, and contested the balance. However, during the

246, 267-268. See, also, *Baltimore & O. R. Co.* v. *Magruder*, 77 F. Supp. 156, 169-170 (Md.), affirmed, 174 F. 2d 896 (C.A. 4th), certiorari denied, 338 U.S. 828. But see *Standard Oil Co.* v. *United States* (N.D. Ohio), decided October 30, 1956 (51 A.F.T.R. 1688).

Although the Government's position in the *Chestnut Securities* litigation was not the position which we here urge, after the decision in *Chestnut Securities* the Government reconsidered the matter and announced that it would follow the ruling of the Court of Claims. G.C.M. 25298, 1947-2 Cum. Bull. 39; Mim. 6444, 1949-2 Cum. Bull. 11. Thereafter, the Government successfully litigated the present question with this same taxpayer. *Consolidated Edison Co. of New York* v. *United States*, 135 F. Supp. 881 (C. Cls.), certiorari denied, 351 U.S. 909. That case was identical to this one, except that it involved different taxable years. The Court of Claims reaffirmed its decision in *Chestnut Securities*, holding that contested local property taxes accrued

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litigation, the taxpayer was required by court order to make additional payments in order to keep its total payment at a prescribed percentage of the tax originally imposed. The Tax Court held that the unpaid taxes did not accrue until the litigation was settled. However, it further held that the contested taxes involuntarily paid by taxpayer during the litigation accrued and were deductible in the years when paid. The court said (12 T.C., pp. 999-1000):

> We hold, further, that amounts of the unpaid and contested taxes which were paid from time to time during the progress of the litigation accrued and were deductible from gross income in the respective years when paid.

when paid under protest, rather than in the later year when the contest was settled.

The court below, reversing the District Court and disagreeing with the Court of Claims and the Tax Court, held that the New York taxes paid by taxpayer were not to be accrued and deducted in the years paid. Its decision, we believe, conflicts with the annual accounting rule and related accrual principles enunciated by this Court. When a taxpayer contests an asserted liability, his obligation to pay is contingent upon the success or failure of the contest and, therefore, all of the events determining his liability do not occur until the contest is concluded. *Dixie Pine Co.* v. *United States*, *supra*; *Security Mills Co.* v. *Commissioner*, *supra*. However, when the taxpayer makes payment during the course of the contest, even though under protest, this contingency disappears since no additional events are necessary to insure satisfaction of the contested liability.[10] The expense has been incurred.

Taxpayer made the payments in question for the avowed purpose of satisfying the tax assessments made by the City against it, so as to remove tax liens from its property and stop the running of interest. (R. 6.) In other words, taxpayer intended to, and did, extinguish its liability. To be sure, taxpayer made its payments under protest and continued its contest with the City, seeking a partial refund. However, after the payment was made, the taxpayer's liability to make payment was satisfied and no longer

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[10] See Point IC, *infra*, pp. 26-30.

contingent; it was the payee City which might become obligated at some future date to make repayment to taxpayer. Future events could not erase the fact that taxpayer's liability had been extinguished by payment, but could affect only taxpayer's right to receive income by way of a refund.

Taxpayer contends that, although payment may have extinguished its liability, the net amount of tax it would ultimately pay, in case it was successful in its refund suit, remained contingent until the suit was settled. Thus, taxpayer urges a "transactional" treatment of income and deductions, in violation of the prescribed annual accounting system. *Security Mills Co.* v. *Commissioner*, *supra*, at 287; *Burnet* v. *Sanford & Brooks Co.*, *supra*, at 365. It is immaterial that there might have been a partial refund in a year subsequent to that of payment, so that from a transactional viewpoint taxpayer's net expenditure (after offsetting the later year's refund) might turn out to be less than that incurred in the year of payment. Under the annual accounting rule, each taxable year is a separate unit for purposes of computing taxable income, *i.e.*, gross income less deductions, regardless of the taxpayer's ultimate gain or loss from a given transaction.

Had taxpayer filed its returns on the cash basis, it unquestionably would have been required to deduct the payments in question in the years of payment, notwithstanding the fact that it immediately brought suit for refund and might later recover all or part of the payments. Since, under the accrual method, income and deductible items are generally reported

in a taxable year prior to that of actual receipt or payment, *i.e.*, in the year when the right to receive or the liability to pay becomes fixed, it would seem to follow, *a fortiori*, that a taxpayer filing its returns on the accrual basis may not postpone a deduction item beyond the year of actual payment. "Accrual, from the debtor's standpoint, preeedes payment, and does not survive it." *Chestnut Securities Co.* v. *United States*, 62 F. Supp. 574, 576 (C. Cls.).

Indeed, even as to a taxpayer reporting on the accrual basis, the payments in question would clearly have been deductible in the years of payment—notwithstanding the suit for refund and the possibility of recovery—had payment been made under a mistake of fact or law. That the taxpayer here made the payment under protest, instead of mistakenly, is of no consequence for income tax accounting purposes: The critical fact is that its liability to pay was discharged by payment. Under the annual accounting rule the liability accrued and was deductible in the year of payment, despite the pendency of a refund claim, as of the close of that year. Cf. *United States* v. *Lewis*, 340 U.S. 590.

In this case, as it happens, the payments made by taxpayer were to the City of New York, an entity not subject to federal income tax. It is nonetheless relevant to consider what the situation would be, from the payee's standpoint, if the payee were also liable for income taxes. The fundamental rule that the tax be computed on the basis of annual accounting periods requires that money *received* under a claim of right and without restriction as to its use be re-

ported as income in the year received, even though the taxpayer-payee may, in a later year, be required to restore the payment. *North American Oil* v. *Burnet*, 286 U.S. 417; *United States* v. *Lewis*, 340 U.S. 590; *Healy* v. *Commissioner*, 345 U.S. 278. This, we submit, supports the correlative proposition which we urge—that the one who *pays* the money in discharge of an asserted liability may claim its deduction only in the year of payment, albeit, in a later year, he may recover the payment.

There are practical considerations which support our view. "Taxation is a practical matter", *Harrison* v. *Schaffner*, 312 U.S. 579, 582, and the orderly administration of the revenue laws requires that taxable events be readily determinable both as to fact and as to time. If there is a contest as to the existence of a liability, if the contest remains unresolved, and if no payment has been made by the alleged debtor to the alleged creditor, the matter is so contingent that there is no ready means at hand for ascertaining the facts of tax significance. The legal conclusion that, in these circumstances, the alleged debtor has not accrued a liability accords with the practicalities. If, on the other hand, a payment has been made in discharge of an obligation, an objective, measurable and definitive occurrence has taken place. This is so even though the payor says that he was overcharged or overassessed, and that he plans to seek restitution of some portion of his payment. There is thus a solid, practical basis for saying that a discharged obligation is invariably an accrued obligation.

There is a further practical consideration. Taxpayers, at least in the vast majority of instances, are constrained by various circumstances to meet their obligations as they fall due. Thus, it cannot be assumed, in the generality of cases, that a businessman who believes that it might be advantageous, from the tax standpoint, to postpone a substantial deduction to a future tax year, would feel free to contrive a contest and to withhold payment, over a substantial period of time, from a creditor. Arrayed against the possible tax advantage would be numerous countervailing considerations—loss of standing in the business community, deterioration of relations with the creditor, impairment of credit generally, the possibility of costly litigation, liability for the payment of interest. There are, however, far less substantial obstacles to calculated tax evasion if one can prevent accrual of an item by making payment and then filing, and keeping on file so long as desired, a paper claim for refund. We disavow any suggestion that the respondent in this case has filed its claims against the City of New York in bad faith, or that it has calculatingly inflated those claims,[11] or that it has failed to prosecute them with diligence. Our point is that taxpayer's theory invites the possibility of abuse. As Judge Clark, in his dissenting opinion, stated the point (R. 48):

> * * * It would seem [under the majority's view] that a taxpayer, by asserting a dispute

[11] Judge Clark does correctly note (R. 48-49) that the aggregate of the claims made during the years 1946-1951 was several times the total recovery.

as to a liability for taxes paid, may postpone the use of such payment as an income tax deduction practically indefinitely until it finds it expedient to settle the dispute with or without receipt of a refund. I presume the dispute must be honestly asserted with perhaps some indicated possibility of success. But these are such minimal requirements as to the large tax liabilities of great corporations as to be meaningless in practice. Obviously a local tax dispute can be prolonged for years; and extrinsic factors such as a corporate reorganization might prolong it yet further. Moreover, I do not see how the principle can be limited only to tax payments; it would seem applicable to other disputed payments generally. Thus ascertainment of the corporate income is substantially taken out of the hands of the revenue authorities; discrimination between taxpayers is accomplished on the basis of the astuteness of the accountants employed; and the sound rule of *annual* federal tax accounting—perhaps the cornerstone of federal revenue collecting—is repudiated in a vitally important detail.

C. ***Taxpayer's remittances to the City of New York were true payments which fully discharged its obligations to the City.***

The taxpayer's obligation to pay the contested property taxes arose when the City assessed and billed the taxes.[12] The obligation was discharged and extinguished when taxpayer paid the assessment under protest; indeed, taxpayer voluntarily made the pay-

[12] Joint Appendix in the court below, p. 58a (on file with this Court, but not reprinted).

ment under protest in order to prevent involuntary payment of the amount assessed (plus interest and penalties) through seizure of its assets. (R. 6.) The obligation having been satisfied by payment, it manifestly did not survive payment, not even as a contingent obligation. All that taxpayer had then was a contingent right to receive repayment, by reason of its ensuing suit for refund. And, as argued above, application of the annual accounting rule required accrual of the obligation in the year it was extinguished by payment.

The court below did not address itself to the critical question whether the payments under protest served to discharge taxpayer's liability for the taxes assessed against it. The majority reasoned that the payments did not require accrual of liability in the year of payment simply because of the contingency that the payments might be refunded to taxpayer in a later year. The decision below thus rests essentially upon the erroneous premise that payment of an assessed but contested tax does not suffice to extinguish the taxpayer's liability to pay it.

In *Rosenman* v. *United States*, 323 U.S. 658, this Court considered the meaning of the term "payment" for purposes of applying the statute of limitations on refund claims. The taxpayer there made remittances under protest to the Commissioner for the purpose of avoiding liens and penalties; this occurred prior to assessment of the underlying tax. The Commissioner placed the sums in a suspense account, and after audit determined a deficiency greater than the amount deposited. The Commissioner then assessed

the deficiency, and applied the deposited funds in partial payment. The taxpayer thereupon paid the balance, and sued for refund. In holding that the taxpayer's remittances were not "payments" on which the statute of limitations had run, the court stressed that the deficiency had not yet been assessed on the date that the deposits were made and that consequently the deposits did not discharge a liability. They were merely payments "in escrow" having the same effect as a security bond, and bearing no interest. The reasoning which impelled the Court in *Rosenman* to hold that payment had not there been made calls for the opposite conclusion here.

The question of what constitutes a payment for purposes of accrual of a tax liability was also presented in *Lewyt Corp.* v. *Commissioner*, 215 F. 2d 518 (C.A. 2d), affirmed on other issues, 349 U.S. 237. In holding that the taxpayer's remittance, which had been placed in a suspense account by the Commissioner, was not a payment, the Second Circuit stated (p. 522):

> * * * the Court [in *Rosenman*] under the facts of that case held that no "tax payment" occurred until there had been an assessment followed by its satisfaction in part out of moneys already deposited with the Collector and in part by additional amounts paid by the taxpayer in response to such assessment, since it was only at that point that interest began to run against the Government on any amount in excess of that ultimately found due as the tax. While we do not read Rosenman to foreclose treating as a tax payment any remittance made prior to assess-

ment, we do think that it supports the view that a remittance that does not *satisfy* an asserted tax liability should not be treated as the "payment" of a tax. *Satisfaction may, as in* Rosenman, *follow from payment of a tax assessed, for such a payment extinguishes the asserted liability, even though the taxpayer is left with an independent claim for refund which survives the discharge of the assessment.* * * * (Emphasis added.)

The payments here involved plainly constituted "payments" in discharge of an asserted tax liability within the rationale of *Rosenman* and *Lewyt*. The taxes had already been assessed by the City; and the payments were made for the avowed purpose of stopping the running of interest, avoiding imposition of penalties, and preventing foreclosure of the City's tax lien. Taxpayer was left with only a claim for refund, which might or might not materialize in a later year. That taxpayer's payments operated to discharge its liability is confirmed by the fact that it was entitled to interest on any amount refunded, from the date of payment.[13] 59 McKinney's Consolidated Laws of New York Annotated (1954 ed.), Tax Law, Sec. 296. *People ex rel. Ottley Estate Corp.* v. *Lilly*, 302 N.Y. 278, 97 N.E. 2d 903.

It is true that taxpayer's payments were "involuntary" in the sense that they were made under threat of economic sanctions. Indeed, virtually all payments of contested tax liabilities are motivated

[13] Taxpayer's refund suit was settled for a lump sum (R. 7), which presumably included an amount attributable to interest.

by similar considerations. However, the test of whether a remittance is a payment does not depend upon the underlying motivation of the payor, but upon whether the debt was thereby discharged. See *Lehigh Valley Railroad Co.* v. *Commissioner*, 12 T.C. 977.[14]

II

Taxpayer, Having Recovered a Portion of Its Payments in Settlement of Its Suit for Refund, Must Include that Amount in Its Gross Income for the Year of Settlement

If, as we contend (Point I, *supra*), the taxpayer properly deducted the entire amount of the payments in question in the years of payment (1946-1950), it follows that the portion refunded in settlement of its refund suit is includible in its gross income for the year of settlement (1951). This result is required not only by the annual accounting rule (cf. *United*

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[14] While the payments here involved were made under protest, they were not prerequisite to certiorari proceedings in the New York courts for review of the validity of the assessment. (R. 6, 18.) Even if prepayment were a condition precedent to judicial review of the assessment, we submit that the result ought be no different since such payment would likewise have discharged the taxpayer's liability. Mim. 6444, 1949-2 Cum. Bull. 11, which indicates otherwise, was issued prior to the decision of the Court of Claims in *Consolidated Edison Co. of New York* v. *United States*, *supra*, since followed by the Commissioner. The Commissioner has acquiesced in the Tax Court's decision in the *Lehigh* case, *supra*, holding that an involuntary payment pursuant to court order of a contested state tax required accrual and deduction of the tax in the year of payment. 1949-2 Cum. Bull. 2.

States v. *Lewis*, 340 U.S. 590), but by the corollary tax-benefit rule codified in Section 22(b)(12) of the Internal Revenue Code of 1939. *Rothensies* v. *Electric Storage Battery Co.*, 329 U.S. 296, 298; *Bartlett* v. *Delaney*, 173 F. 2d 535 (C.A. 1st), certiorari denied, 338 U.S. 817; *Union Trust Co.* v. *Commissioner*, 111 F. 2d 60 (C.A. 7th), certiorari denied, 311 U.S. 658. In its reply brief in the court below (p. 20), taxpayer conceded that, if the Government's position with respect to the deduction issue is correct, the Government's position on the refund issue is also correct.[15] As to this proposition, therefore, we presume that the parties are in agreement.

CONCLUSION

Taxpayer's payments of the contested taxes were properly deducted in its returns for the respective years of payment (1946-1950), and the amount refunded to it in 1951 was properly reported as income

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[15] Taxpayer also concedes that if its contentions are upheld it should not be permitted to have the benefit of a double deduction of any part of the payments—once in the year of payment, and again in the year the refund suit was settled. Statement on Behalf of Respondent, filed in reply to the petition for certiorari (p. 3).

in its return for that year. Accordingly, the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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FEBRUARY, 1961

☆ U. S. GOVERNMENT PRINTING OFFICE: 1961 903393 859